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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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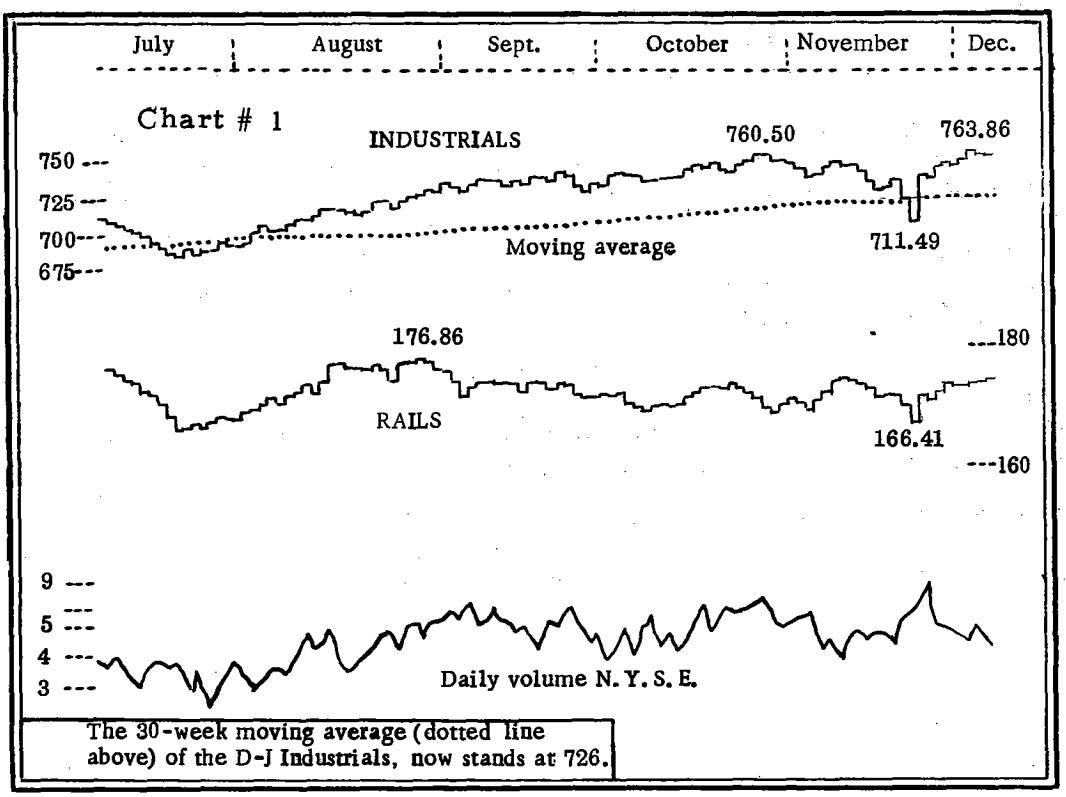
THE MARKET I am not able to take a poll of Wall Streeters, but I would guess that the majority of professionals expect higher prices from here well into 1964. I gather this from what I read, from investment advisors and brokers with whom I speak, and from the current record level of debit loans (i.e., margin accounts). Margin is an instrument which is dear to the heart of the speculator. The current $5.6 billion in margin accounts offers mute testimony to the bullishness of Wall Street's speculators.

Despite the Street's hopes, however, I doubt if many of those who are on margin are fully aware of the dangerous abnormalities which have been built into both the current price structure and the current breadth-price relationship (i.e., the relationship of the Industrial Average and the advance-decline ratio).

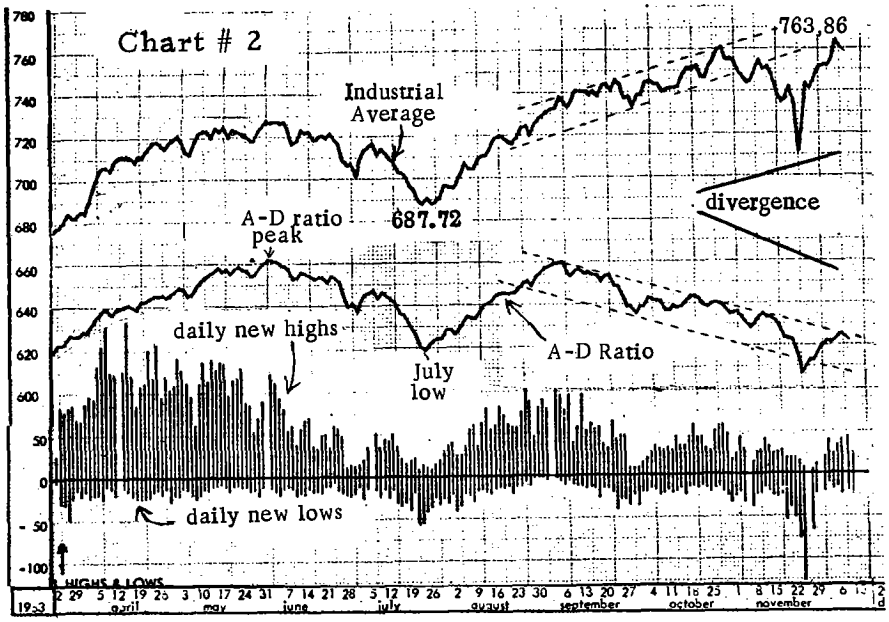
As far as Dow's Theory is concerned, the termination of many important rises has been signalled by the refusal of one Average to confirm the indications of the other. The Rail Average struck a 1963 peak on August 30 at 176.86 (see Chart #1). Industrials have continued to push higher, and on December 5, the senior Average recorded an all-time high of 763.86. Despite the strength exhibited by the Industrials, Rails have stubbornly refused to better their August 30 high. In the past, such action has, at best, been associated with periods of uncertainty. At worst, non-confirmations of important new highs have marked the beginnings of secondary reactions or bear markets.

From the standpoint of the breadth-price relationship, we note (Chart #2) that the A-D ratio recorded its 1963 peak on May 31 -- six months ago. The 1963 peak in the A-D ratio has been followed by a succession of new (unconfirmed) highs in the Industrial Average. The entire history of breadth and price suggests that sustained major advances in the Industrial Average are dependent upon a harmonious "in gear" relationship between the senior average and the A-D ratio. Furthermore, there seems to be a definite time factor which governs the breadth-price relationship. In the past, when there has been a time lag of four months or more between new Industrial highs and the last peak on the A-D ratio, the ensuing action has not been favorable. The following years saw a peak in the A-D ratio -- following four to nine months later by new (unconfirmed) highs in the Industrial Average: 1919, 1929, 1947, 1957, 1959, 1962, and now 1963. Based on all previous case histories, the early (May) 1963 peak in the A-D ratio, which has been followed as recently as last week by a new (unconfirmed) Industrial high, should breed action which will be unfavorable to those who hold stocks.

Aside from the time element in the breadth-price relationship (as discussed above), there is the matter of the full divergence between breadth and price, a divergence which was completed between September 5 and September 23 (see Letter 231). In the past, these rare divergences between price and breadth have been followed by declines which included a number of selling climaxes. Furthermore, these post-divergence declines have tended to terminate only when the Industrial Average and the A-D ratio have finally put themselves back in gear together on the downside. On November 22, the A-D ratio broke below its July, 1963, low (see Chart #2). Technically, this calls for a comparable penetration by Industrials below their own July low of 687.72.



The 30-week moving average (dotted line above) of the D-J Industrials, now stands at 726.



Is such a decline in the cards? I believe it is. When will it occur? My answer is that it will probably occur when least expected. Could Industrials push considerably higher prior to such a decline? They could, but the move would be so dangerous that I would not advise subscribers to follow it. It was this type of action (a continued parting of the ways for breadth and price) which occurred during 1928-29, and this possibility is discussed in the following section.

PERSPECTIVE One hears many knowledgeable points of view regarding the market. At present, the professional view is sharply split between two "opposing" schools". Last week, in fact, I happened to have two of these opposing gentlemen in my office. I believe readers may be interested in what these two men, Mr. Essentially Over and Mr. Grandsurge A. Head, had to say. The following is taken directly from my notes:

Mr. Grandsurge A. Head: "Since the June, 1962, lows, the odd-lot public has been stubbornly and persistently selling into a rising market. In fact, the seventeen consecutive months of odd-lot selling since mid-1962 constitute the longest period of such selling on record. The obvious question we must ask is — amid all this selling by the public, who has been doing the buying (buying, I might add, which has pushed the Industrial Average from 535.76 in June, 1962, to 760.50 in October, 1963)? The answer is that professional money was buying all during 1962-63 — while the public was 'turning in its chips'.

"We see further proof of this in the sky-rocketing debit balances (margin accounts), and, of course, margin is used extensively by professionals. Additional evidence may be seen in the sluggish almost sideways movement of the low-priced stocks and the continual drift of equities on the American Exchange. The fact is that the professional money (as it usually does) has been buying quality shares while foresaking secondary and 'doggy' issues completely. The secondary merchandise is the sort of stuff that is moved by the public — as and when they come into the market.

"And my bet is that the public is going to come into the market. When they do, we'll see this market turn highly speculative, we'll see volume expand 7 to 12 million shares daily, we'll see the Industrial Average rise into the 800 and above area. Such a move will probably occur between now and mid-1964. But when it's over — watch out! Because this final surge is going to finish off the entire post-World War II inflationary binge, and in the midst of all the coming 'hoop-la' and 'New Era' talk, I expect the market to fall apart. Following which, the current generation is going to witness its first true market smash and post-war depression. And as far as I'm concerned, what happened in 1962 was just a preview of what I expect to occur after the coming surge. But remember, before any trouble, we're going to get a whopper on the upside."

Mr. Essentially Over shrugs his shoulders: "It's all very interesting, my friend, but allow me to present a few comments of my own. I agree with your whole thesis except for one minor point -- I believe that the surge you talk about has already occurred! It took place during 1959, 1961 and 1962-63. We've already had the necessary froth and excitement; enough so that market historians will be able to look back over the 1959-63 period and say: 'Ah, those were the wild years on Wall Street.'. If I may refresh your memory, low-priced stock boomed during 1958-59; 1960-61 saw the first authentic 'new issue' market since 1945; and the expressions 'growth' and 'glamour stock' became household words during 1960-63. Volume of transactions in recent years has surpassed 1928-29 on numerous occasions, and we have seen long periods during which the public were avid buyers of stocks.

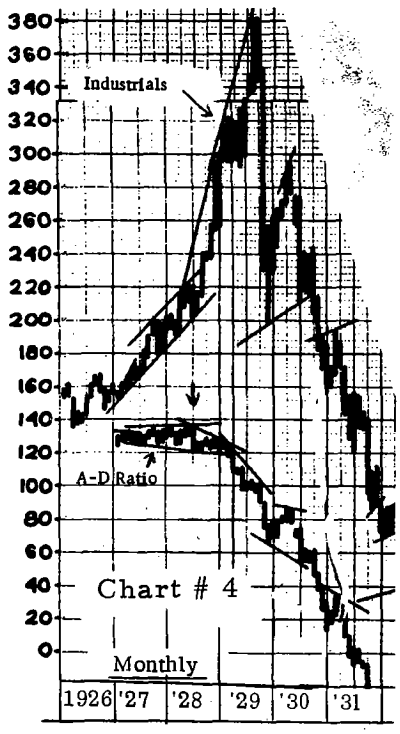
"Furthermore, let's look at the market performance over the past four years. Actually, ever since the August 3, 1959, peak of 678.10, the Industrial Average has been attempting to extend its gains. The fact remains, however, that each attempt by Industrials to push beyond the 678.10 high has been accompanied by distribution in a majority of stocks, a slight further extension beyond the previous Industrial peak -- and then important trouble.

"Thus we witnessed a slide which started immediately after the Industrial high of 685.47 recorded in January, 1960. Following the subsequent October, 1960 low, we tried again, and in December, 1961, Industrials rose to a new high of 734.91. The 1962 crash followed, and up we went for the third time. Now we're back in the mid-700's again and trying as hard as ever. On September 5, 1963, Industrials bettered their 1961 high — but on that very day a divergence between Industrials and the mass of stocks (the A-D ratio) began. This was the third such divergence to occur since 1959, and it is worth noting that each divergence started just as the Industrial Average hurdled its previous major peak.

"No, Grandsurge, my friend, I don't agree with you about (another) 'final explosion' ahead. We've tried to get that explosion going for four years, but most stocks are now lower than they were at the '59 peak. How many tries does the market need before

it admits failure? I say that we've already seen the boom, and that the next major move will be down — not up."

So saying, the two men turned to me and asked me what I thought. Having no way out, I was forced to give an opinion. "I am not at all convinced about the coming boom idea. I believe that there could be trouble ahead, rather than a final 'blow-off'. However, I am impressed by the fact that the public has not entered the market during 1962-63, and I would like to present a theory of my own.



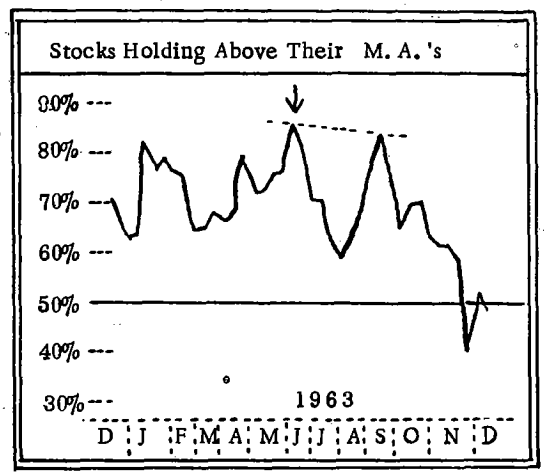
"Most people do not realize that the 1921-29 bull market ended in a very strange way. It terminated with the advance-decline ratio (i.e., the majority of stocks) 'topping out' in late 1928, following which the Industrial Average embarked upon a fantastic rise to its September, 1929, peak. This meant that most investors made little or nothing during the final 1929 advance — unless, of course, they were 'smart' enough to have held the correct Dow stocks. In other words, the Industrial Average boomed, but ironically, the majority of stockholders probably lost money during the final explosive rise which ended the 1921-29 bull market (in illustration, I showed the gentlemen the chart which appeared in Letter 233, and I have reproduced the chart again on this page).

"I believe that there is a good chance that the A-D ratio has 'topped' for the duration of this market. I believe that if the Averages do surge up from here, the move is going to resemble 1928-29 in that the average portfolio is going to lose money on balance. Only one thing would change my mind on this point: if a major decline were to occur first, and Industrials were to drop below their July lows I would actually be more hopeful than I am at present. Such a decline (below the July low of 687.72) would serve to put Industrials and the A-D ratio "back in gear" (on the downside) again. It is well to remember that past divergences have always ended with Industrials and the A-D ratio getting together on the downside (confirming each other through preceding lows). In other words, I would view any renewed surge in the Average (from this level) merely as a dangerous continuation of the divergence which began on September 5, 1963. But I would view any important decline from here as part of a possible base from which a broad rise might develop. It's a case of 'up' being dangerous but 'down' being potentially bullish. Time will tell, gentlemen."

COMMENTS FOR THE SHORT TERM The last Letter referred to the penetration of the A-D ratio below its July low, a penetration which was unconfirmed by the Industrial Average. It was stated that this was technically the formula for a rally "... and particularly for a rally in that one segment of the market which has stubbornly resisted decline, the Industrial Average itself."

The rally did take place, and on December 5, Industrials rose to a new all-time high of 763.86. Rails, although moving in direction, have not yet confirmed the move (by rising to a 1963 high of their own — above 176.86). The main body of stocks acted sluggishly on the rally, and this fact is underscored by the desultory performance of the A-D ratio (see Chart #2) which is still holding within its downward channel. Daily new highs expanded to the 40 level on December 5, but considering the historic Industrial peak, this was the poorest performance of the daily new highs this year. The steady contraction of the new highs can be seen on Chart #2. Volume at and around the December 5 peak was unimpressive, and the record Industrial high has not (so far) brought in the volume which might be expected to accompany a primary penetration.

Although I am not a devotee of the "seasonal trend" approach, it should be remembered that the month of December has been the surest rally month of any year. Since 1937, 21 out of 25 Decembers have been characterized by higher Industrial prices. Therefore, the odds (from the seasonal standpoint) favor a further yearend rally. Nevertheless, because of the poor technical situation, if the market continues its December rally I would not follow the move — and I would guess that whatever strength is exhibited will be followed by weakness around the turn of the year.



STOCKS Of 432 representative stocks tabulated here each week, 212 or 49% are now holding above their 200-day moving average. As seen on the chart at right, the violent rebound from the 39% recorded on the "assassination lows" took the percentage to 52% last week and back to 49% this week. This study has now turned unfavorable.

The writer spends a good part of each weekend going over the charts of all stocks on the American and New York Stock Exchanges. Over the past few months, two things have become apparent: (1) Since late May (when the A-D ratio recorded its peak), the action of the majority of stocks has varied from fair to bad. An

extraordinarily large number of issues are now near their lows for the year, while an amazingly few stocks are near the highs for 1963. On the Amex, it is obvious that a bear market is (and has been) in progress. Many stocks on the junior Exchange are now off as much as 25 to 75% from their high of the past year or so. (2) I note that the action of many stocks must now be characterized as "erratic". A given stock will rush up on high volume, only to drop back a few weeks later. Another issue will form a triangle, push out of the formation, then flop back and go "dorment". It is as if stocks are playing a "hide-and-seek" game with traders. Traders buy them, they get "locked in", and they wait to get "bailed out". This exasperating and disappointing action is all the more disturbing because it is taking place against a background of glowing business news. I have seldom seen economic forecasts that are more uniformly bullish. For instance, Standard & Poor's sees personal income, gross national product, disposable income, consumer spending, total employment, cost of living, corporate profits, and dividends all going to record highs in 1964! If all this is true, then what is the matter with the majority of stocks? They have either discounted all the forthcoming news — or the technical situation is not ready for them to act on it.

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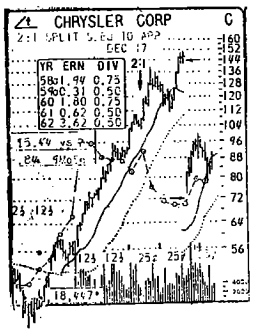

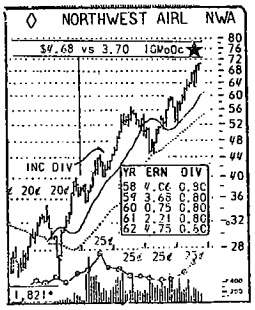

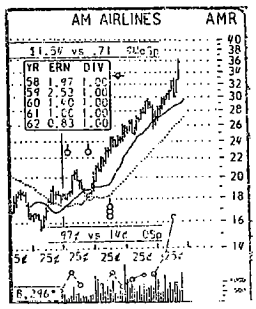

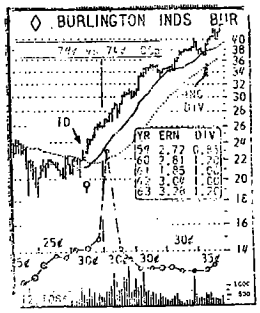

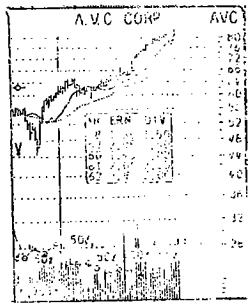

Only three groups have continued to act better than the market during the entire period since mid-1962. Those groups which have shown consistently improving relative strength (R. S.) are Autos, Airlines and Textiles. Many leading stocks in these groups are now in straight-up or "stilt" formations. As such they are vulnerable to sharp corrections or major reversals. I have included small charts (above) which illustrate these stilt movements. History shows that many stilt movements may provide the most violent downside action when the trend turns down (i.e., IBM in 1962).

Two stocks which appear interesting at this time are shown in the charts below. Lowenstein is still far under its high of 31 recorded in the mid-1950's. The stock is a laggard in the strong textile group. Its problem was that it was very heavily in a shrinking industry — cotton. It has now diversified and is showing good progress. This stock used to be a real money-maker. Technically, LST acts well, and the downside risk is not high. Bucyrus-Erie is a good actor in a poor group. After acting worse than the market for four years, BY has recently reversed to the upside in R. S. The weekly chart suggests accumulation, and here again the downside risk does not seem unreasonable. Back in 1956 this largest manufacturer of excavating equipment sold for 56.

Chart #2 of the A-D ratio and chart of Bucyrus courtesy of Traders Research, 1431 Pearl Avenue, Alton , Illinois 62003.
Tabulation of 432 stocks and small charts on this page courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.